DRAFT

STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date:	**04/16/13**	Bill No:	**Senate Bill 376**
Tax Program:	**Sales and Use Tax**	Author:	**Correa**
Sponsor:	**Author**	Code Sections:	**RTC 6377.4**
Related Bills:	**SB 235 (Wyland)** **SB 412 (Knight)** **AB 486 (Mullin)** **AB 653 (Perez, V.)** **AB 1326 (Gorell)**	Effective Date:	**Upon enactment but exemption operative 01/01/17**

This analysis will only address those provisions that impact the State Board of Equalization (BOE)

BILL SUMMARY

This bill provides manufacturers, software publishers, and their affiliates a 6.5% income tax credit for sales tax reimbursement or use tax they paid on purchases of qualifying tangible personal property, until January 1, 2017.

Beginning January 1, 2017, the bill provides manufacturers, software publishers, and their affiliates a 6.5% sales and use tax exemption for qualifying tangible personal property purchases.

ANALYSIS

CURRENT LAW

Except where the law provides a specific exemption or exclusion, California's Sales and Use Tax Law[1] imposes the sales tax on all retailers for the privilege of selling tangible personal property at retail in this state or the use tax on the storage, use, or other consumption in this state of tangible personal property purchased from a retailer.

Generally, sales or use tax applies to the sale or purchase of tangible personal property to persons who use the property to manufacture, produce or process tangible personal property. A manufacturer's taxable purchases include machines, tools, furniture, forklifts, generators, and office equipment. A software publisher's taxable purchases include computer equipment, such as servers, routers, switches, power units, network devices, hard drives, processors, memory modules, and other computer hardware and components.

Conversely, tax does not apply to sales of tangible personal property when the purchasers physically incorporate the property into the manufactured article to be sold. For example, no tax applies to a manufacturer's raw material purchases when, prior to making a taxable use, they become an ingredient or component part of the manufactured article to be resold.

[1] Part 1, Division 2 of the Revenue and Taxation Code (RTC) (commencing with Section 6001).

California Alternative Energy and Advanced Transportation Financing Authority (CAEATFA). Existing law[2] contains a specific sales and use tax exclusion[3] for tangible personal property purchased for certain approved manufacturing projects. In 2010, legislation[4] authorized the CAEATFA to approve sales and use tax exclusions for tangible personal property used for the design, manufacture, production, or assembly of advanced transportation technologies, alternative energy source products, components or systems. In 2012, legislation[5] was enacted to authorize CAEATFA to approve sales and use tax exclusions related to advanced manufacturing projects until July 1, 2016. The law[6] provides a $100 million cap for these exclusions.

CAEATFA's approval of the exclusions is based on whether the project results in a net benefit to the State, with consideration to both fiscal and environmental benefits.

California's sales and use tax rates. Effective January 1, 2013, California imposes a statewide 7.5% sales and use tax on taxable tangible personal property sales and purchases. The table below shows California's various sales and use tax rate components (the table excludes voter-approved city and county district taxes):

Rate	Jurisdiction	Purpose/Authority
3.9375%	State (General Fund)	State general purposes (Revenue and Taxation Code (RTC) Sections 6051, 6051.3, 6201, and 6201.3)
1.0625%	Local Revenue Fund 2011	Realignment of local public safety services (RTC Sections 6051.15 and 6201.15)
0.25%	State (Fiscal Recovery Fund)	Repayment of the Economic Recovery Bonds (RTC Sections 6051.5 and 6201.5)
0.25%	State (Education Protection Account)	Schools and community college funding (Section 36, Article XIII, State Constitution)
0.50%	State (Local Revenue Fund)	Local governments to fund health and welfare programs (RTC Sections 6051.2 and 6201.2)
0.50%	State (Local Public Safety Fund)	Local governments to fund public safety services (Section 35, Article XIII, State Constitution)
1.00%	Local (City/County) 0.75% City and County 0.25% County	City and county general operations (RTC Section 7203.1, operative 7/1/04); Dedicated to county transportation purposes
7.50%	Total Statewide Rate	

PROPOSED LAW

Beginning January 1, 2017, this bill provides a 6.5% sales and use tax exemption for a "qualified person's" purchases of:

[2] RTC Section 6010.8.
[3] An "exclusion" means the transfer of the property is neither a "sale" or "purchase" and is therefore excluded from the application of the sales and use tax. An "exemption" involves a retail sale that, absent an exemption in law, would otherwise be subject to the tax.
[4] SB 71 (Ch. 10, Stats. 2010, effective March 24, 2010).
[5] SB 1128 (Ch. 677, Stats. 2011, effective January 1, 2013).
[6] Public Resources Code Section 26011.8.

- Tangible personal property to be used 50% or more in manufacturing, processing, refining, fabricating, or recycling of property (i.e., machinery, equipment, parts, belts, shafts, computers, software, pollution control equipment, buildings and foundations), as specified.
- Tangible personal property to be used 50% or more in research and development.
- Tangible personal property to be used 50% or more in maintaining, repairing, measuring, or testing any qualifying equipment.
- Tangible personal property purchased for use by a contractor, as specified, for use in the performance of a qualified person's construction contract. The qualified person must use the property, however, as an integral part of any manufacturing, processing, refining, fabricating, or recycling process or as a research or storage facility in connection with the manufacturing process.

This bill defines "qualified person" as either:

- o A trade or business that is primarily engaged in manufacturing activities, as described in North American Industry Classification System (NAICS) codes 3111 to 3399, inclusive, and software publishing activities as described in code 5112, of the 2012 edition of or
- o A qualified person's affiliate, if the affiliate is a member of that person's unitary group, as specified.

The bill defines "fabricating," "manufacturing," "primarily," "process," "processing," "refining," "research and development," and "useful life." The bill also specifies the tangible personal property included or excluded from the proposed partial exemption.

The proposed partial exemption excludes:

- o Any tangible personal property primarily used in administration, general management, or marketing,
- o Consumables with less than a one year useful life, and
- o Furniture, inventory, equipment used in the extraction process or equipment used to store finished products that have completed the manufacturing process.

The bill excludes from the exemption any city, county, or district tax levied pursuant to the Bradley-Burns Uniform Local Sales and Use Tax Law or the Transactions and Use Tax Law. The proposed exemption includes the remaining state and local sales and use tax components.[7]

Beginning January 1, 2014 and before January 1, 2017, this bill provides a 6.5% income tax credit for sales tax reimbursement or use tax paid on manufacturers' and software publishers' purchases of similar qualifying tangible personal property. This credit falls under the purview of the Franchise Tax Board and is not discussed in this analysis.

BACKGROUND

For a ten-year period ending December 31, 2003, the law provided new manufacturers a state General Fund sales and use tax exemption on their purchases of specified manufacturing equipment. Also, the law provided manufacturers income and corporation tax credits (MIC) of 6% for similar equipment placed in service in California. Similar to the exemption proposed in this bill, the partial exemption and credit related to

[7] 3.9375% General Fund, 1.0625% Local Revenue Fund 2011, 0.25% Education Protection Account, 0.25% Fiscal Recovery Fund, 0.50% Local Public Safety Fund, and 0.50% Local Revenue Fund.

equipment used primarily for manufacturing, refining, processing, fabricating or recycling. New manufacturers could claim the partial exemption or the MIC. However, existing manufacturers could only claim the MIC.

This partial exemption and MIC contained a conditional sunset date. The law required these provisions to sunset when manufacturing employment,[8] less aerospace employment, failed to exceed January 1, 1994 manufacturing employment by more than 100,000. On January 1, 2003, the employment figures fell below the 1994 number by over 10,000. The partial exemption and MIC therefore sunset at the end of 2003.

Legislative History. Since then, numerous bills have been introduced to reinstate, expand, or modify the exemption and/or MIC, but all failed to pass. Bills introduced during the last two Legislative sessions that exempted similar purchases from sales and use tax include:

Bill No.	Session	Author	Proposed Exemption
ABx1 40	2011-12	Allen	3.9375% exemption for new businesses and 3% for existing businesses engaged in manufacturing, software production, biotechnology research and development, and renewable power generation facilities.
AB 103	2011-12	Budget Committee	5% exemption for new manufacturers and software producers, and 1% for existing manufacturers and software producers.
AB 218	2011-12	Wieckowski	5.25% exemption for manufacturers and software producers.
AB 303	2011-12	Knight	5% exemption for new manufacturers.
AB 979	2011-12	Silva	5% exemption for manufacturers and software producers and affiliates.
AB 1057	2011-12	Olsen	5% exemption for manufacturing, research and development, and air pollution mitigation by manufacturers and affiliates.
SB 116	2011-12	Dutton	Same as ABx1 40 above.
SB 395	2011-12	Dutton	5% exemption for manufacturing and software production.
AB 1911	2011-12	Donnelly	3.9375% exemption for manufacturing and software production.
AB 1972	2011-12	Huber	Full exemption for manufacturing, software production, biotechnology research and development, and renewable power generation facilities.
SB 686	2011-12	Padilla	Full exemption for biotechnology manufacturing and research and development activities.
AB 810 and AB 829	2009-10	Caballero	5% exemption for qualifying tangible personal property, and 6% exemption for sustainable development equipment investments, by manufacturing and software production.
AB 1719	2009-10	Harkey	6% exemption for manufacturing

[8] As determined by the Employment Development Department

Bill No.	Session	Author	Proposed Exemption
AB 1812	2009-10	Silva	6% exemption for manufacturing and software production
AB 2280	2009-10	Miller	Full exemption for manufacturing.
SB 1053	2009-10	Runner	6% exemption for manufacturing and software publishing and their affiliates
SBx6 18	2009-10	Steinberg & Alquist	6% exemption for specific manufacturing and software production activities
SBx6 8 & SBx6 44	2009-10	Dutton	6% exemption for manufacturers and software publishers and affiliates

COMMENTS

1. **Sponsor and Purpose.** Sponsored by the California Manufacturers and Technology Association, this bill intends to help level the playing field with California's competitors. According to the author, "Today, there are only four other states that do not provide some exemption for equipment purchases from payment of sales tax. This burden is relatively large in California due to the high rate of sales tax in the state and a complex regulatory environment. California has long been recognized as a national leader of manufacturing, but in recent years, California manufacturers have been crippled by high taxes and overly burdensome regulations. To remain competitive, we must support meaningful economic incentives that will keep businesses and good paying jobs in California."

2. **NAICS Codes 3111 to 3399 and 5112 include manufacturers and software publishers, respectively.** NAICS Codes 3111 to 3399 include all establishments primarily engaged in manufacturing activities. This includes manufacturers in the aerospace sector, textiles, pharmaceuticals, printing, food, and more.

   NAICS Code 5112 includes establishments primarily engaged in computer software publishing or publishing and reproduction. Software publishing establishments carry out the functions necessary for producing and distributing computer software. This includes activities such as design, documentation, installation, and support services to software purchasers. The software publishing industry produces and distributes information mostly by CD-ROMs, through the sale of new computers with preloaded software, or through the Internet.

3. **Affiliates' purchases also qualify for the proposed exemption.** In addition to the entities described above, manufacturers' and software publishers' affiliates' purchases qualify for the exemption.[9] As proposed, the law does not require that the affiliates be engaged in manufacturing or software publishing activities. Instead, their purchases of qualifying tangible personal property need only be for use in a manner described in the bill. For example, an affiliate of a television manufacturer may be primarily engaged in the activity of recycling. All the affiliate's equipment purchases for that activity qualify for the proposed exemption. This is true whether or not the manufacturer or software publisher operates primarily outside this state. The original manufacturing exemption discussed previously did not have this provision. Potentially, this new provision adds a new level of complexity for tax administration purposes, and results in additional unknown sales and use tax revenue losses.

[9] Those that are members of the entity's unitary group for which a combined report is required under RTC Article 1 (commencing with Section 25101) of Chapter 17 of Part 11 of the Corporation Tax Law.

4. **The bill's scope applies to more than manufacturers, software publishers, and affiliates.** We recommend the bill specify that a qualified person's activities be *primarily* those described in the referenced NAICS codes. This issue generated a dispute when the BOE and FTB administered the previous MIC. In an FTB appeal, the BOE ruled that a grocery store's meat processing and bakery operations constituted "manufacturing." The BOE approved the grocery store's claimed MIC for its associated equipment investments despite that the grocery store was not primarily engaged in one of the identified NAICS codes. Without more specificity in this bill, the state's revenue losses could potentially be significantly more than anticipated or identified in this analysis. Our suggested amendment is identified on page 9 as "Amendment 1."

5. **Partial exemptions complicate tax administration.** Currently, most sales and use tax exemptions apply to the total applicable sales and use tax. However, California law contains five partial exemptions, currently at a 5.50%[10] rate:

   (1) Farm equipment and machinery,

   (2) Diesel fuel used for farming and food processing,

   (3) Teleproduction and postproduction equipment,

   (4) Timber harvesting equipment and machinery, and

   (5) Racehorse breeding stock.

   These partial tax exemptions complicate retailers' return preparation and processing. Return errors occur frequently with claimed partial exemptions. Accordingly, the BOE's return processing workload increases.

   Also, this bill proposes a new 6.5% exemption rate. This requires a sales and use tax return revision with a new, separate return computation. If enacted, some retailers may be required to segregate the 6.5% exempt sales, the 5.50% exempt sales, fully exempted sales (e.g., a sale for resale or interstate commerce sale), and fully taxable sales. This adds a new level of complexity, and potentially increases tax reporting errors. Accordingly, the BOE's tax administrative functions and retailers' reporting obligations become more complicated.

6. **The term "property" needs clarification.** The bill exempts a qualified person's "property" purchased for use in manufacturing, fabrication, processing, etc. Manufactured "property" is generally construed to mean the traditional manufacturing of tangible items, not the creation of intangibles or the provision of services and utilities. However, the bill does not expressly limit the term to tangible personal property purchased for use in manufacturing or fabricating. Taxpayers could assert that the bill includes intangible property creation or the provision of services and utilities. To avoid any unintended consequence, we recommend the term "property" be replaced with "tangible personal property." Suggested amendments are identified on page 9 as Amendments 2, 3, and 4.

7. **Related legislation.** Similar bills introduced this year include:

   - **SB 235 (Wyland)** – provides manufacturers and their affiliates a 3.9375% exemption for their qualifying tangible personal property purchases.

[10] 3.9375% General Fund, 1.0625% Local Revenue Fund, 0.25% Fiscal Recovery Fund, and 0.25% Education Protection Account.

- **SB 412 (Knight)** – provides aerospace products and parts manufacturers a 3.9375% exemption for their qualifying tangible personal property purchases.
- **AB 486 (Mullin)** – provides manufacturers, software producers, various researchers and developers, and their affiliates, a 5.25% exemption for their qualifying tangible personal property purchases.
- **AB 653 (V. Perez)** – provides manufacturers, software publishers, biotechnology research entities, and renewable power generator facilities, and their affiliates a state and local exemption for their qualifying tangible personal property purchases.
- **AB 1326 (Gorell)** – provides unmanned aerial vehicle manufacturers a state and local exemption for their qualifying tangible personal property purchases.

COST ESTIMATE

A cost estimate is pending to determine costs to reprogram for the partial exemption, revise and process returns, notify retailers, audit claimed exemptions, and answer inquiries from taxpayers and the general public.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

NAICS 31-33 (Manufacturing). The United States Census Bureau's *Annual Survey of Manufacturers* (ASM) reports California manufacturing capital expenditures data (machines and equipment, buildings). In fiscal year (FY) 2010-11, California manufacturers' capital expenditures amounted to an estimated $11 billion. We assume this amount includes manufacturers' research and development-related capital expenditures.

NAICS 5112 (Software Publishers). The Census Bureau's *Annual Capital Expenditures Survey* (ACES) reported U.S capital expenditures data (machines and equipment, buildings) for software publishers. For California expenditures, we looked at the 2007 *Economic Census* software publishers' data and estimated that the ratio of California to U.S revenue or sales receipts for software publishers equals 28%. We applied the 28% to U.S capital expenditures (ACES). In FY 2010-11, California software publishers' capital expenditures amounted to an estimated $1.4 billion.

For FY 2010-11, census data reveals total capital expenditures of $12.4 billion (NAICS 31-33, $11 billion + NAICS 5112, $1.4 billion).

The partial sales and use tax exemption becomes operative January 1, 2017. Using the most recent forecast of business equipment investment from *IHS Global Insight*, a national economic forecasting firm, we estimated expenditures as follows:

Capital Expenditures – California (in billions)

	FY 2016-17	FY 2017-18
NAICS 31-33	$18.3	$19.2
NAICS 5112	$2.2	$2.3
	$19.2	$20.2

REVENUE SUMMARY

The annual revenue loss from exempting from 6.5% sales and use tax for manufacturers' (NAICS 31-33) and software publishers (NAICS 5112) purchases of qualifying tangible personal property amounts to:

Sales & Use Tax Loss (in billions)

	(6 month impact) FY 2016-17	FY 2017-18
State Rate 6.5%	$0.62	$1.31

Qualifying Remarks. The revenue estimate is understated to the extent that the bill (1) does not limit the proposed partial exemption to establishments *primarily* engaged in manufacturing and software publishing, and (2) the proposed partial exemption applies to affiliate purchases, as defined. Our estimate is based on those establishments that are *primarily* engaged in the qualifying activities. For the affiliate purchases, we do not have information related to the revenue loss associated with these purchases.

In addition, the revenue estimate is overstated to the extent that it does not account for manufacturing-related sales and use tax exclusions authorized by CAEATFA. The 2009 legislation has resulted in sales and use tax revenue losses of approximately $37 million in 2010, $4.7 million in 2011, and $8.7 million in 2012. We have no information on exclusions related to advanced manufacturing purchases authorized by the 2012 legislation. However, the law caps the allowable sales and use tax exclusions for both programs at $100 million annually.

This revenue estimate does not account for any changes in economic activity that may or may not result from enactment of the proposed law.

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PROPOSED AMENDMENTS TO SB 376

AMENDMENT 1

On page 4, line 12, add "primarily" after "is" and before "engaged"

AMENDMENT 2

On page 3, line 5, add "tangible personal" after "altered" and before "property"

AMENDMENT 3

On page 3, line 22, add "tangible personal" before "property"

AMENDMENT 4

On page 6, line 10, add "tangible personal" before "property"